ARCO OIL AND GAS CO.

IBLA 87-561 Decided May 25, 1989

Appeal from a decision of the Director, Minerals Management Service, denying a transportation allowance for royalty valuation purposes. MMS-87-0094-OCS.

Set aside and remanded.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties--Outer Continental Shelf Lands Act: Oil and Gas Leases

In the absence of a market for oil at the wellhead where production would ordinarily be sold and valued, the deduction of a transportation allowance from the value of the oil at the nearest available market has been allowed. Although the point of first "sale" of oil is generally an indicia of the existence of a market, the substance of a transaction will prevail over form and a decision rejecting a transportation allowance for oil "sold" to a pipeline will be set aside where it appears from the record that the oil was held for the account of the lessee, the lessee received no consideration for "sale" of the oil, the oil was redelivered to the lessee at the end of the pipeline, and the only consideration paid was a $2.50-per-barrel service charge to the pipeline.

APPEARANCES: Robert C. Smith, Esq., New Orleans, Louisiana, for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE GRANT

ARCO Oil and Gas Company (ARCO) has appealed from an April 24, 1987, decision of the Director, Minerals Management Service (MMS). The Director's decision affirmed a ruling of the Chief, Royalty Valuation and Standards Division, Royalty Management Program (RMP), MMS, denying ARCO's request for a transportation allowance for oil produced on Outer Continental Shelf oil and gas Lease No. OCS-G 2950, Main Pass Block 148.

ARCO owns an undivided one-third working interest in the production under Lease No. OCS-G 2950, Main Pass Block 148, offshore Louisiana. By letter dated March 24, 1986, ARCO requested a transportation allowance in the amount of $280,252 for costs incurred during 1985 in transporting its crude oil from Main Pass Block 148 through the pipelines of Main Pass 151 Pipeline Company (Pipeline) and Shell Oil Company to an onshore point of sale at the Empire Terminal in Louisiana. ARCO's production is metered
and measured for royalty purposes at Main Pass Block 151 where ARCO delivers the oil to Pipeline pursuant to an agreement executed by ARCO on October 6, 1983. The agreement provides for the sale and delivery by ARCO to Pipeline of its production from the lease at a price based upon Shell Oil Company's (Shell) Texas/Louisiana Gulf Coast posting for crude oil of like gravity. Both title and risk of loss pass to Pipeline upon delivery under the agreement. The agreement further provides for the sale by Pipeline to ARCO of an equal amount of similar oil to be delivered into the pipeline at Shell's Pompano Gathering System at Main Pass Block 150, with title and risk of loss passing to ARCO upon delivery to Shell's pipeline. ARCO pays Pipeline a price equal to the same Shell posting plus a service charge of $2.50 per barrel. The agreement also establishes an invoice procedure requiring Pipeline to prepare a single net invoice each month, detailing the barrels sold by ARCO to Pipeline and the barrels sold by Pipeline to ARCO plus the service charge paid by ARCO.

The oil placed in Shell's Pompano Pipeline System at Main Pass Block 150 is transported to Shell's pipeline facility at Main Pass Block 69 from which point it is delivered by pipeline to the Empire Terminal onshore. At Main Pass Block 150, ARCO transfers title to Shell pursuant to a barrel-for-barrel exchange agreement dated January 30, 1984, and amended May 15, 1985, and September 4, 1985. That agreement requires Shell to deliver an identical amount of oil back to ARCO at the Empire Terminal in Plaquemines Parish, Louisiana. In return, ARCO pays Shell a "location differential" of $0.38 per barrel delivered to the Shell Pompano Pipeline at Main Pass Block 150 plus a pipeline tariff and "terminalling" charges to cover the cost of transportation of the oil from Main Pass Block 69 to the Empire Terminal.

By letter dated March 24, 1986, ARCO requested a transportation allowance for the costs of moving its 1985 production from the point of production to the Empire Terminal. On December 19, 1986, the Chief, Royalty Valuation and Standards, RMP, denied ARCO's request after determining that the agreement with Pipeline provided for the payment of monetary consideration in addition to a transfer of title at Main Pass Block 151, thus constituting a sale. He further stated that

> [i]t is MMS policy to grant transportation allowances for the reasonable actual costs incurred by the lessee when it is necessary to move the royalty portion from the lease to a point of sale remote from the lease. Since the sales point for this lease is at Main Pass Block 151, any transportation costs incurred beyond this point would not be eligible for a transportation allowance. Thus, ARCO's request for a transportation allowance for this lease cannot be granted by MMS.

ARCO appealed this decision to the Director, MMS, arguing that RMP erroneously found that the agreement provided for the payment of consideration to ARCO for the oil since ARCO did not receive any compensation for the oil. ARCO further asserted that, although a transfer of title to the oil occurred, MMS wrongly concluded that the first commercial sale had taken place because the sole purpose of transferring title was to convey risk of loss to Pipeline, not to establish ownership. ARCO pointed out that neither Pipeline nor Shell was free to sell to a third party the quantity of oil which it was bound to deliver for ARCO's account.

The Director affirmed the denial of the transportation allowance. He based his conclusion on the language of the agreement between ARCO and Pipeline which "makes it clear that the production is sold by ARCO to Pipeline." He noted that, not only does the agreement provide that risk of loss and title pass from ARCO to Pipeline upon delivery to Pipeline's facilities, but it also establishes the price to be paid to ARCO. He found that the fact that the invoice to ARCO provided only for a net amount due equal to the $2.50-per-barrel service charge did not contradict the terms of the agreement because the payments had simply been netted for purposes of invoicing. He determined that "the invoicing procedure set forth in the agreement states ARCO sold its production to Pipeline. In fact, the invoice provided by ARCO also shows specific prices attached to the barrels sold to Pipeline. Thus, the netting of the prices paid by ARCO and Pipeline is solely an administrative convenience" (Decision at 3).

The Director found that the terms of the agreement created an actual sale and, thus, did not support ARCO's contention that the sole purpose of the transfer of title was to transfer the risk of loss during transportation to Pipeline, not to establish ownership. The Director concluded that,

> [a]s previously stated, the RMP policy is to share only in the reasonable actual costs of transporting the royalty share to the point of sale or the nearest point where sales could reasonably be expected to take place. The point of sale is defined as the point where title transfers and a consideration is received for the product. The point of sale in this case is at the point of delivery into Pipeline's facilities.

(Decision at 4).

In its statement of reasons for appeal (SOR), ARCO argues that MMS' denial of its request for a transportation allowance does not comport with the MMS policy of allowing transportation allowances. ARCO also contends that the denial is in direct contradiction to RMP's findings and conclusions granting transportation allowances to ARCO for the 1983 and 1984 production years based on the same agreements involved here.

ARCO argues that MMS erroneously concluded that a sale had occurred at the point of delivery to Pipeline by failing to consider ARCO's allegations as to the intent of the agreement between it and Pipeline. ARCO asserts that no foundation has been established for the determination that the point of sale occurred at the point of delivery into Pipeline's facilities.

Appellant contends that the agreement does not provide for the payment of any consideration to it. Rather it simply establishes an accounting for the barrels exchanged and a service fee of $2.50 per barrel paid by ARCO to Pipeline for transporting its oil to the Shell pipeline connection. ARCO asserts that Pipeline did not acquire a product that it was free to sell into commerce, and that Pipeline retained title and risk of loss only during transportation of the oil. ARCO alleges that the agreement could only be characterized as a transportation agreement because it provides for the redelivery of like volumes without any price differential.

ARCO contends that MMS' refusal to grant the requested transportation allowance solely on the basis of its characterization of the agreement as a sales contract was arbitrary and capricious because it represents a reversal of previous agency action. ARCO bases this argument on RMP's approval of ARCO's 1983 and 1984 transportation allowances pursuant to the same agreements involved here. ARCO notes that the November 26, 1985, letter approving the 1984 transportation allowance provided that this allowance was to be used as the tentative allowance during calendar year 1985. ARCO alleges that these earlier approvals established binding precedent from which MMS could depart only if it provided a reasoned explanation. Since MMS's denial of the 1985 allowance "was based on a narrow and unsupported conclusion that delivery of oil for subsequent redelivery constituted a sale" (SOR at 12), its deviation from the earlier approvals had no reasonable basis. In short, ARCO asserts that the Director's denial was arbitrary and capricious because

> it does not comport with longstanding MMS policy to grant transportation allowances when oil is transported to a sales point off the lease; is based on incorrect factual findings; and is a reversal of its findings and conclusions involving the same appellant, the same lease, and the same contracts, for the years 1983 and 1984 when a transportation allowance was allowed.

(SOR at 13).

In its answer, MMS agrees that the Department has a longstanding policy of granting transportation allowances, but notes that such allowances are not required to be approved in all cases. MMS states that, when such an allowance is granted, it is from the point of production to the first available market, and that "MMS does not grant a transportation allowance for transportation costs incurred beyond the sales point where value for royalty purposes is determined by the price paid for oil delivered at that sales point" (Answer at 3). Since ARCO transferred title of the oil to Pipeline and received monetary consideration for the oil when it delivered the oil to Pipeline at Main Pass Block 151, it sold the oil at that point, and MMS established royalty value based upon that sales price. ARCO's request for a transportation allowance only covered costs incurred between that sales point and the Empire Terminal. Therefore, MMS concludes that it properly denied the request because it was for costs accruing beyond the sales point where royalty value was determined.

[1] The provisions of the Outer Continental Shelf Lands Act, as amended, 43 U.S.C. || 1331-1356 (1982), and appellant's lease issued

pursuant thereto require the payment of a royalty on production of oil and gas based on a specified percentage of the amount or value of the oil and gas produced. The relevant regulation at the time the MMS decisions were issued provided that the "value of production shall never be less than the fair market value" and recognized certain pertinent criteria to be considered in determining the value: "(a) The highest price paid for a part or for a majority of like-quality products produced from the field or area; (b) the price received by the lessee; (c) posted prices; (d) regulated prices; and (e) other relevant matters." 30 CFR 206.150 (1987). 1/ One of the relevant factors taken into consideration is the cost of transportation of oil to an onshore market where there is no market at the offshore point of production. In the absence of a market for oil at the wellhead where production would ordinarily be sold and valued, the deduction of a transportation allowance from the market value of the oil at the nearest open market has been upheld. United States v. General Petroleum Corp., 73 F. Supp. 225, 263 (S.D. Cal.), aff'd, Continental Oil Co. v. United States, 184 F.2d 802 (9th Cir. 1950); Shell Oil Co., 52 IBLA 15, 88 I.D. 1 (1981); C & K Petroleum, Inc., 27 IBLA 15 (1976); Kerr-McGee Corp., 22 IBLA 124 (1975); The Superior Oil Co., 12 IBLA 212 (1973).

On the other hand, transportation costs have been disallowed where the costs claimed were for transportation beyond the point of the nearest potential market. See The Superior Oil Co., supra. In Superior the Board denied a barging allowance for transportation of crude oil from the onshore pipeline terminal where crude oil produced from offshore leases was received to another point where appellant marketed its oil. In rejecting this element of transportation costs, the Board noted the existence of a market for oil in the vicinity of the onshore terminal and the potential for abuse if a deduction were allowed for the costs of transporting oil beyond the nearest available market. 12 IBLA at 228. In Kerr-McGee, supra, the Board set aside a decision denying a transportation allowance for costs associated with a pipeline to convey oil from the leasehold to the point of the first available market, expressly distinguishing the facts of the case from those present in Superior Oil. In reaching this conclusion we noted that if the lessor took its royalty in kind (as it had a right to do), rather than in value, it was entitled to its share of the oil free of expenses at the leasehold and the lessor would be obligated for the expense of transporting the oil to market. We found it would produce "an anomalous result if the Government royalty interest was, in effect, chargeable with transportation when taken in kind, but not when taken in value." 22 IBLA at 128. This brings into focus the critical issue in the present case: whether the transportation allowance ARCO is seeking is for transportation of the oil beyond the point of the first potential market. See Kerr-McGee Corp., supra at 127-28.

1/ This regulation has now been superseded by the extensively amended royalty product valuation regulations at 30 CFR Part 206 effective Mar. 1, 1988. 53 FR 1218-25 (Jan. 15, 1988). The regulations at 30 CFR Part 206 were amended to specifically provide for transportation allowances and to establish procedures for determining those allowances. 30 CFR 206.104, 206.105, 53 FR 1222-25 (Jan. 15, 1988).

Reviewing the record in this case, it is true that ARCO's agreement with Pipeline is characterized therein as a "buy/sell" agreement and provides for the transfer of title to ARCO's lease production delivered to Pipeline at Main Pass Block 151. The agreement further provides that Pipeline will deliver to ARCO into Shell's Pompano pipeline system a quantity of oil equal to ARCO's delivery to Pipeline with title passing to ARCO as the oil enters Shell's pipeline. The price of the oil delivered to Pipeline is defined in the agreement in the identical manner as the price of the oil delivered to ARCO--a price tied to Shell's Texas/Louisiana Gulf Coast Posting for crude oil of like gravity. The only difference is that the agreement requires ARCO to pay a $2.50-per-barrel service charge for the oil transported. A copy of an invoice dated August 15, 1986, appearing in the record shows a specified number of barrels of oil at a specified price delivered to Pipeline and reflects an identical number of barrels of oil at an identical price plus a $2.50-per-barrel charge delivered to ARCO. The invoice reflects a total billing to ARCO of $2.50 per barrel of oil delivered. This confirms that despite the description of the agreement as a buy/sell agreement, the only consideration given is the $2.50-per-barrel service charge for transportation of the oil by Pipeline. This also lends credence to appellant's contention that Pipeline had no authority to dispose of the oil which it conveyed for ARCO. While as a general rule the point of first sale is an obvious indication of the point of first market opportunity, it would be inappropriate to apply this rule without regard to the nature of the transaction involved. The real issue is whether the Pipeline transaction represents the first available market for the oil from ARCO's lease. It appears this question must be answered in the negative. We find nothing in the record which indicates the existence of an offshore market for the oil for ARCO's lease.

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is set aside and the case is remanded.

C. Randall Grant, Jr.
Administrative Judge

I concur:

Kathryn A. Lynn
Administrative Judge
Alternate Member